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The deficit country is absorbing more, taking consumption and investment together, than its own production; in this sense, it is drawing upon savings made abroad. Whether this is a good bargain or not depends upon the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin. If they permit an excess of investment over home savings, the result depends on the nature of the investment.

Joan Robinson, "Reconsideration of the Theory of Free Trade," ***Collected Economic Papers, Volume IV*****, 1973**

THE EMPEROR HAS NO CLOTHES

America's economic recovery and its likely strength have been and remain the central preoccupation in economics around the world. In the consensus view, the U.S. economy will record in this year's second half its strongest pace of growth since the late 1990s. According to a monthly survey of 53 economic forecasters conducted by the *Wall Street Journal Online*, its seasonally adjusted annual growth rate during the current quarter will be 4.7% and 4% in the fourth quarter.

While a few economists have been warning that this recovery's actual pace may disappoint, our own view, as explained in detail in the last letter, is that the U.S. economy's higher growth rate in the second quarter was totally deceptive. Focusing strictly on the hard economic data, like employment, personal income, production, business fixed investment and profits, we completely fail to see any recovery at all in the United States.

Ever since 2001, the United States has been running monetary and fiscal stimulus of unprecedented largess. In July, the government's tax cut and rebate checks turned an income gain of $19 billion into a $120 billion gain in disposable income.

In the bullish consensus view, the medicine is finally working. Above all the upward revision of the second-quarter real GDP growth rate from 2.4% to 3.1%, following 1.4% each in the two prior quarters, has virtually caused euphoria.

Knowing these are annualized growth rates is the first reason why we are still unable to see a sustained, let alone a self-sustaining, economic recovery in the United States. When American economists speak of 4% growth in the coming quarters, they really mean 1%, and that is a far cry from what used to rank as a cyclical recovery. Growth rates of postwar recoveries in the United States averaged 5.4% over the first two years after recession, and that needed very little monetary and fiscal stimulus, as against less than 3% growth currently.

The second reason for our disbelief is that U.S. GDP has been heavily bolstered by government spending. In the fourth quarter of 2002, it accounted for 24.5% of nominal GDP growth, in the first quarter of 2003 for 40.7% and in the second quarter for 38.2%.

A third reason is that the recovery completely fails to show in the current-dollar data. In these dollars in which all economic activity takes place, GDP grew 0.99%, after 0.94% in the first quarter, an acceleration hardly worth mentioning. But measured in chained dollars, it more than doubled from 0.35% to 0.775%. Taking the big boost from government spending into account, it was more slowdown than acceleration.

The fourth and most important negative point is that the trumpeted recovery in business fixed investment, in particular in high tech, is just another statistical mirage. In the second quarter of 2003, overall business fixed investment in structures, equipment and software, measured in current dollars, amounted to $1,119.9

billion, slightly down in comparison with $1,126.8 billion in the first quarter of 2002. Measured in real terms, chained dollars, it was up $64 billion, or 0.5%.

A GROSSLY IMBALANCED GROWTH PATTERN

It hardly needs specific explanation that a true economic recovery essentially has to come from a balanced rise in consumer spending and business investment spending. But what really happened to the two during the first half of 2003, being generally hailed as the start of the U.S. economy's final recovery?

Let us first look at the changes in aggregate GDP. Measured in current dollars, it grew by $99.6 billion in the first quarter and by $105.5 billion in the second quarter, hardly an acceleration.

Looking at the demand components, growth of consumer spending, its biggest component, slowed between the two quarters from $87.1 billion to $83.1 billion. Nonresidential fixed investment dipped in the first quarter, but recovered in the second quarter to its earlier level. From first to second quarter, the growth of government spending slowed from $40.7 billion to $33.6 billion, and that of residential investment from $21 billion to $6 billion. Not one single GDP component rose. The sharply rising trade deficit subtracted $11.1 billion from GDP growth in the first quarter and $23.8 billion in the second.

But this dismal picture, measured in current dollars, radically changed for the better after the statisticians had treated the numbers with their price indexes. GDP growth, measured in chained dollars, surged from $33.8 billion to $73.5 billion. Growth in consumer spending, down in current dollars, went steeply up from $33 billion to $62.4 billion, and growth in government spending even shot up from $1.7 billion to $31.7 billion.

Yet by far the single biggest contributor to this sudden surge in real GDP growth from the first to second quarter came from the calculation of the price deflator for computers. Measured in current dollars, this investment inched up by $0.8 billion in the first quarter and by $6.3 billion in the second quarter, but the hedonic deflator boosted the two numbers in real terms to $15.3 billion and $38.4 billion. Hedonic pricing of computers in the first quarter accounted for 43% of real GDP growth and for 44% in the second.

The bullish consensus, flatly disregarding the overwhelming hedonic component, immediately hailed the sharp rise in computer investment as the rapid comeback of high-tech investment. Wall Street celebrated with the NASDAQ up 42% since March. In its absence, nonresidential investment remained dead in the water across the board.

CONSUMPTION IS SLOWING

Consumer spending, propelled by the housing and mortgage refinancing bubble, is supposed to lead the recovery. It is growing, yes. But even here acceleration is completely missing. There were temporary boosts from promotion programs by the car manufacturers and also from tax cuts and tax refunds, but there always followed a new relapse.

Consumer borrowing is on the rampage as never before. In 2000, at the height of the bubble, it increased by $558.8 billion. This accelerated during 2001, the recession year, to $614.6 billion, and in 2002 to $771.8 billion. During the first two quarters of 2003, it has further soared to $837.2 billion and $1,000.2 billion, at annual rate.

The debt binge is working, for sure. But on closer look, we notice that more and more debt produces less and less consumer spending.

Consumer spending, increases per quarter ($billions)

2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2
74.3	80.5	106.0	64.7	87.1	83.1

Source: National Income and Product Accounts

The fact is that the growth rate of consumer spending during the past fours quarters (2.9% y-o-y) is far below its average rate of growth (more than 5%) in prior post recession periods.

It is true that creating the greatest consumer borrowing binge, as well as the greatest monetary and fiscal stimulus, in history has so far prevented a deeper recession in the United States. However, this bubble has rapidly diminishing effects, and above all, it has completely failed to induce an accelerating upward movement. All the acceleration in real GDP in the second quarter that is being hailed as proof of an ongoing recovery has come from government spending and the hedonic pricing of computers. Take the two away, and there is more economic sluggishness.

THE DECISIVE FAILURE

This has an obvious reason — all the monetary and fiscal stimulus has flagrantly failed to revive the economic components that are indispensable for a true self-sustaining economic recovery. For that it needs ***sustained*** growth in employment, personal income, business fixed investment and profits. But all these key ingredients of economic growth remain flat or even negative.

In contrast to previous business cycle recoveries, in which personal income used to increase strongly, this time it has remained sluggish. Instead, the rise in consumer spending is being exclusively driven by heavy borrowing.

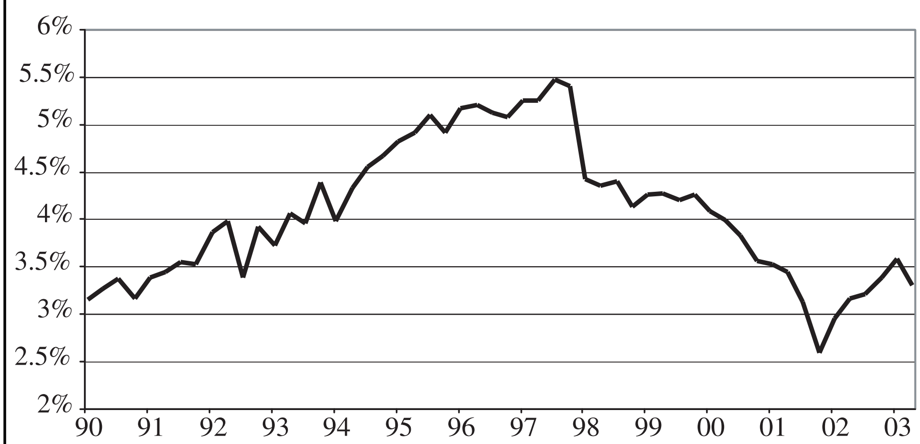
But as just expounded, consumer spending has been distinctly slowing, even though consumer borrowing is beating ever-new records. There can be little doubt that the sharp rise in long-term interest rates is sure to implement still more restraint.

Still, the consensus is convinced that the U.S. economy's sustained recovery from slow growth has definitely started. We keep reading such reports with utter amazement because this assessment flagrantly conflicts with the very weak economic data from official sources.

We have realized that this prevailing optimism about the U.S. economy owes everything to a number of indexes that we call artificial data, such as the Conference Board, Institute for Supply Management, the University of Michigan consumer sentiment, including in particular the stock market, all ranking as early indicators. American economists and investors are unusually obsessed with the idea of spotting a change in the economy before it happens.

In the past few months most of these early indicators have been grossly upbeat in comparison to the official data. Just recently, the Federal Reserve published its production index for August. It inched up from 110.1 to 110.2, and was 1% below its level a year ago. The output of consumer goods even dipped 0.2%. There was a single big increase y-o-y: defense equipment, up 6.5%.

After-Tax Profits of Nonfinancial Businesses as a Percentage of GDP



Source: Bureau of Economic Analysis

This protracted stagnation of production, fully two years after the recession ended, compares with steep increases by 7–8% during the first two years after recessions in past cycles.

The decisive point here really is the growing disparity

between demand growth and production in the United States. The most striking example of this gross imbalance between supply growth and demand growth are the disparate paths of retail sales — up 6.3% y-o-y — and manufacturing — down 1.6% y-o-y. We think this particular gross imbalance is symptomatic of the situation across the whole U.S. economy. America has the most powerful credit machine in the world, but it lacks saving and investment.

The comparison between the two figures says that over the past year the entire increase in the U.S. domestic demand for goods, as reflected in sharply rising retail sales, went to foreign producers. Literally nothing of that demand growth ended with domestic producers.

Essentially, this fact raises a few critical questions about the supposed existence of large excess capacities. Why are they not used to meet the rapidly rising demand? There are two possible answers: first, the excess capacities do no exist; second, they exist, but they are not competitive.

THE GREATEST STIMULUS IN HISTORY

To repeat: looking for a healthy economic recovery, it is necessary to focus on the development of employment, personal incomes, business fixed investment and profits. But all these have been and remain the weak spots in virtually all economies around the world, and in particular in the U.S. economy.

Measured by the official GDP data, the U.S. economy is performing best among the major industrialized countries. Favorable comparisons with Germany and France, the two big laggards in the euro zone, enjoy great favor as evidence of how well the U.S. economy is doing. It definitely helps to divert attention from the fact that the U.S. economy is performing at its worst in the whole postwar period.

Drawing international comparisons, we would also take into account that governments and central banks have reacted very differently to the slowdown of their economies. While the torrent of monetary and fiscal measures in the United States seems to strike many people as highly positive, to us it has a bad taste of desperation and panic. We prefer the calmness of the European Central Bank.

In the euro zone, new public borrowing during the past few years has been stagnant around €70 billion per year, staying around 1% of GDP. Increases in the German and French deficit have been offset by improvements in other countries.

This compares with the United States' huge swing from fiscal surplus in 2000 (around $200 billion) to a soaring deficit, hitting at least $500 billion in 2003, adding up to a swing in fiscal stance of about 7% of GDP.

Just the same, a vast difference has been prevailing in the monetary policy between the two central banks. The European Central Bank displays personified reluctance, both in policy action and in public pronouncements. In short, it continues to act in the traditional tenure of central banks to avoid interference in the markets, other than through its policy instruments.

The American Fed under Alan Greenspan has radically broken all rules and traditions of caution and reluctance in central banking. Not only has it acted with unprecedented aggressiveness in lowering its interest rates and in opening its money spigots, but at the same time it has also taken recourse to a ruse that old central bankers would have regarded as scandalous: In order to lower longer-term interest rates, it has been bluntly inviting leveraged carry trade in bonds with the assurance that the Fed will keep interest rates low for a long time even if the economy recovers.

Central bankers were always on the alert to limit the availability of liquidity for financial speculation, regarding it as an evil that distorts market prices and market valuations. Mr. Greenspan has recklessly pursued the opposite aim. His policy model for the economy is based not on income creation through production, but on credit creation through asset bubbles.

With many highly bullish proclamations about a new paradigm U.S. economy, he became the most prominent cheerleader of America's stock market bubble. Remarkably, he did this although the economy and the stock market were booming. In the same vein, he is blatantly encouraging unlimited carry trade in bonds, fueling, in turn, the housing and mortgage refinancing bubble. But this time, it smacks more of desperation about the economy's protracted sluggishness.

WHAT AILS THE U.S. ECONOMY?

American policymakers have certainly done their utmost to stimulate the economy. Still, we have always warned that they will fail. The explanation is that hard-core, structural economic and financial dislocations, having accumulated from the credit excesses during the boom, make the economy unresponsive to such traditional stimulus. But what exactly are these dislocations?

The bullish consensus has two popular explanations for the economy's protracted stalling. The one says that a broad-based overhang of productive capacity, built up during the bubble years, is suppressing capital investment by spoiling corporate pricing power and squeezing profits. But a temporary, drastic curtailment of new investment is solving the problem.

The other explanation, lately coming into fashion, is that unprecedented gains in productivity inhibit a recovery in employment and thereby also in income growth. A study just published by the Fed argues that the experience in the last two recoveries may be pointing to a new type of business recovery driven largely by productivity increases rather than employment gains.

We strongly dispute both contentions.

As to the first argument, we flatly deny that there was an investment boom in the late 1990s. It is physically impossible for the country with the most rampant consumer borrowing and spending binge and collapsing savings to have an investment boom.

It is true that corporations, too, ran amok as borrowers. But the bulk of their borrowing served to finance their merger and acquisition mania, buying existing factories at prices vastly in excess of book values. A steep rise in corporate indebtedness between 1996–2000 by $1,726 billion, or 56%, compared with a rather modest increase in their stock of equipment and software by $609 billion.

This false impression of an investment boom arose mainly from two features. Nonresidential fixed investment soared during the 1990s in real terms from $641.7 billion to $1,324.2 billion, or 106%. But this was gross investment before depreciations. Only investment above the amount of depreciations, or net investment, adds to the economy's capital stock.

As business investment shifted heavily towards short-lived high-tech equipment, depreciations took off with increasing speed. Net investment grew during the boom years from $199.1 billion in 1995 to $437.7 billion in 2000.

YEARS OF RAMPANT OVERCONSUMPTION

Manifestly, America's bubble economy of the late 1990s had its center in the most profligate consumer borrowing and spending binge in history. In particular the fact that consumption soared as a share of GDP towards 90% and higher, as against a long-term ratio of about 67%, bears this unmistakably out.

This really is the U.S. economy's key imbalance that is obviously the root cause of its protracted sluggishness. The underlying basic fact is that Americans, in the aggregate, have been spending and continue to spend in excess of their current income.

What is wrong with that? Why should excess consumption strangle economic growth? The short answer is, consumer spending in excess of income inherently means also in excess of production, and this part of consumer spending essentially emigrates to foreign producers, adding nothing to the U.S. GDP.

But that is not all. At the same time, the overconsumption creates a variety of growth-impairing imbalances in the economy, both on the macro and micro level. Among them the most spectacular and also the most impeding to economic growth is the monstrous trade deficit.

In America, it is the consensus view that such a deficit is simply typical and normal for a country that is growing faster than the rest of the world. That is not at all true. The normal experience over decades and centuries is the exact opposite. Fast-growing economies used to have an export surplus, like Germany and Japan in the earlier postwar decades.

The reason is that economies with high economic growth used to be high-investment and high-savings countries. They chronically consume less than they produce, and that makes for the export surplus. America, in contrast, is a low-investment and low-savings country where consumption has now exceeded current production for many years. That, and nothing else, is the key cause of the trade deficit.

THE GROWTH AND PROFIT KILLER

As we have explained in detail in past letters, America's biggest, though widely unrecognized, problem is its huge trade deficit, running now at an annual rate of $550 billion. There is a complacent view that trade outflows and capital inflows simply offset each other. That is true, of course, in the overall balance of payments. But its internal effects are very different.

The decisive adverse effect of the huge trade deficit on U.S. economic activity arises from the fact that the money spent for purchases abroad represents for American businesses an equivalent loss of revenue that essentially hurts profits. It actually devastates the profits of American corporations when the money spent abroad comes from the wage bill of American businesses. And that actually means a double whammy for U.S. profits. U.S. businesses have the wage costs and forego the revenue.

Manifestly, the capital inflows are not undoing these adverse effects of the trade deficit on domestic incomes and profits. They do not flow into the real economy, building factories; they flow into the financial markets, overwhelmingly purchasing existing financial and real assets. And that means the absence of any income effects.

It is the traditional American view that consumption, being by far the biggest component of GDP, is therefore also its most important component that essentially leads recoveries. America had in the past years more consumption than ever, but capital investment and profits disappeared.

That is precisely what European growth theory expects to happen. If consumption grows to excess, it crowds out investment and spills over into imports. With its tremendous size, the trade deficit is America's main growth and profit killer.

STILL MORE CONSUMPTION

It has to be realized that with this big wound in the economy's body, a sustained strong recovery in the United States is not possible. And it has to be further realized that there is but one way to check this massive drag on U.S. domestic economic activity: ***by curbing the consumption excess on the one hand and raising the share of saving and investment in GDP on the other. In particular, manufacturing investment has to increase rapidly***.

Pointing this out, we realize that this is not going to happen. First of all, such a major shift in the allocation of resources is extremely difficult to engineer. Boosting consumption at the expense of investment is an easy task in America. Second, there is virtually no recognition of this problem in the United States. Everybody cries for more and more consumption in the vain hope that it will stimulate investment. It chokes it.

Nor is there the slightest concern in the United States about the collapse of national saving. Even policymakers regard rising stock and house prices as a perfect and far more pleasant substitute. They have lost sight of the fact that investment requires the withdrawal of physical resources from the production of consumption goods for the production of capital goods.

This happens only to the extent that private households save, that is, do not spend a corresponding part of their current income. America's notorious pro-consumption policies are only prone to prevent investment.

BUT THE PRODUCTIVITY MIRACLE

Most remarkable are, of course, the ever-more stellar figures for productivity growth. Over the past two years, it has averaged 4.1%, about 1.8 percentage points higher than the long-term average of 2.3%, measured over the past 10 years.

How important is productivity growth? More precisely, how bullish is it for the economy and the stock market? Productivity growth is computed — we quote an official report — *"by dividing the nominal output of a given sector by an estimated price index and a measure of hours worked. The trend in all three of these variables are subject to measuring error."*

There seems to be a widespread view that it implicity creates economic growth. A recent Federal Open Markets Committee statement said, *"an accommodative stance of monetary policy, coupled with still-robust underlying growth in productivity, is providing ongoing support to economic activity."*

The fact is that productivity growth just by itself moves absolutely nothing in the economy. Obviously, it does not create employment. Nor does it create income either for employees or for businesses. It is a pure statistical number, no more, no less.

What really matters are the economic effects of productivity growth primarily on the income of wage earners and business profits. The trouble with America's stellar productivity growth numbers is that such positive income effects are completely missing.

Wage and salary payments in the private sector during the last few years have literally collapsed. In 2002, the wage and salary payments of the private sector edged up a miserable $3.8 billion, compared with a steep increase by $321.1 billion in the boom year 2000. During 1997, wage and salary disbursements had amounted to $275.4 billion.

Nor did the productivity miracle, thanks to collapsing wage payments, translate into a profit bonanza for the business sector. Profits of the nonfinancial sector have fared at their worst during the whole postwar period, and it was definitely not deflation that ravaged profits. Overall, consumer and producer prices continued to rise. Taking the stellar productivity growth together with the rise in inflation rates, though slowing, there ought to have been a profit miracle.

It is certainly a strange productivity miracle that devastates wage and profit growth, and it is hard to see how this can be bullish for the economy and the stock market. For us, there is no question that the calculations underlying the U.S. productivity miracle are badly flawed.

From an economic perspective, the central issue about productivity growth is really how it has been achieved. As a rule, both capital investment and innovation contribute to increased labor productivity, that is, to the increase of output per worker. But the old economists focused exclusively on capital investment. Today's American economists focus exclusively on innovation.

But there is a crucial difference in the economic effects of capital investment and innovation. Just by itself, the latter is unable to bring about higher economic growth. For that to happen, it also needs demand creation, and that happens only in the case of productivity growth that results from capital spending. It alone generates the economic effects that are crucial and indispensable for growing prosperity.

In addition to creating productivity growth, higher capital spending creates in the same vein higher demand, higher production and higher tangible wealth. All three are missing in the stellar productivity growth in the United States.

Being fully aware of the central role of capital formation for the creation of growth and prosperity, savings and investment were the main concern of the old economists. It was apodictic for them that where they exist, high productivity growth can be taken for granted.

With capital spending badly lacking, American policymakers and most economists have discovered a completely new source of demand creation: asset bubbles, that is, rising stock and house prices. But the trouble is, by prolonging the consumer borrowing and spending binge, they only worsen the U.S. economy's main evil: overconsumption.

PROFITS WILL REMAIN DISMAL

It is meanwhile generally recognized that an economic recovery in the United States with sufficient momentum and staying power invariably requires a strong revival of capital investment. Though hopes for this to happen are riding high, so far it remains missing. We do not see that the necessary conditions for an investment recovery are improving.

Its protracted sluggishness has a variety of reasons, but two are certainly most prominent. The one is the extremely poor profit performance, and the other one are weak balance sheets, bedevilled with excessive leverage.

Trying to assess the profit prospects, we focus on four relevant flows, two on the macro level, and two on the micro or corporate level. The first two are the trade deficit and personal savings; the second two are interest expenses and net investment.

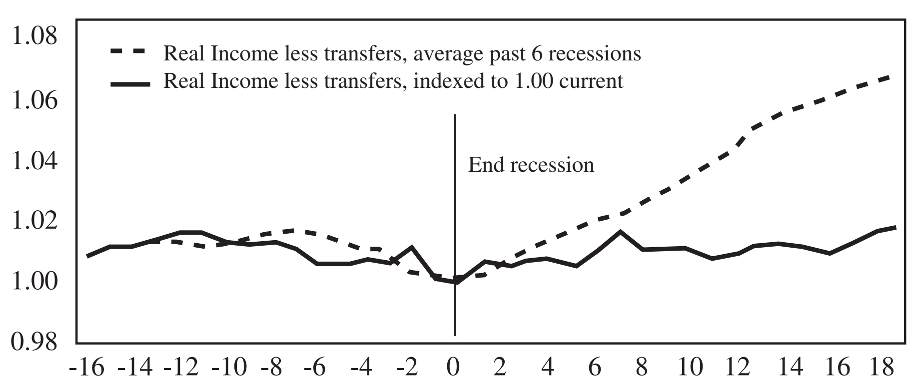
As already explained, the trade deficit is America's single biggest profit killer. Expecting much weaker growth for the U.S. economy than the consensus, we presume sharply slower growth of the deficit, implying a moderation of its inherent profit squeeze.

In our view, the greatest danger for the U.S. economy, in general, and for business profits, in particular, looms in a possible or rather probable major increase in the personal savings rate. If so, it would play havoc with profits.

Let us briefly recapitulate how changes in savings impact profits. When the consumer saves, he reduces business revenues relative to business wage expenses. Higher personal saving, thus, lowers profits. Implicitly, lower savings increases business revenues relative to its wage expenses. Spending more than he earned from businesses, the American consumer during the past several years has been the corporate sector's main profit source.

But the return of a savage bear market in stocks and a fading or bursting of the housing and mortgage refinancing bubble that we expect will force the American consumer to save substantially more from current incomes. In the absence of a sharp recovery in capital investment, it would smash profits and finally pull the rug out from under the economy.

Income growth



Source: Kleinwort Benson Wasserstein

Obviously, corporations have no direct influence on these two macro flows, savings and the trade deficit. Looking for profit-impacting influences on the micro or corporate level, we focus on interest expenses and net investment spending.

In all past cyclical recoveries, these two internal corporate flows have played a key role in enhancing profits. As the Fed reduces interest rates, plunging

interest expenses are the one, and sharply rising net investment is the other one. But this time, both are dead in the water.

Between 1990–93, for example, the corporate interest bill plunged from $156 billion to $105 billion in response to easier money. In line with soaring indebtedness, that bill for nonfinancial firms surged between 1997–2000 from $120 billion to $194 billion. Despite the Fed's extremely sharp interest rate cuts, this time it has remained stubbornly above $190 billion.

As to capital spending, there is a paradox about its correlation with profit creation. Higher capital spending depends crucially on profit prospects, but actual profits depend crucially on higher capital spending. Net fixed investment is typically the most important profit source in the capitalist economy. Looking at businesses as a whole, this derives from the fact that investment spending in the aggregate increases overall business revenues without generating an immediate expense. No expense is incurred until the depreciation charges set in.

Sharply rising business fixed investment has been the regular feature of all cyclical business recoveries in the postwar period. It is indispensable both for its demand effects and in particular for its specific profit effects. Even two years after the proclaimed end of the 2001 recession, both effects remain badly missing.

ANOTHER MYTH — REBUILDING BALANCE SHEETS

Hand in hand with the deceptive stories about a profit and investment recovery goes the just as deceptive story that corporations have been rebuilding their balance sheets.

The balance sheet problem of U.S. corporations is quickly stated: total liabilities of nonfinancial corporate businesses have risen by $3.56 trillion, or 55%, since 1997. Tangible assets participated with $1.6 trillion, among them equipment and software with $579 billion.

By far the biggest stride on the asset side was made by "Miscellaneous assets," soaring by $3.3 trillion, or around 50%. It includes the famous "goodwill" that firms create by capitalizing the amounts that, when acquiring other firms, they have paid in excess of book values. Malinvestments would certainly be a better description.

In other words, most of the borrowed money was used to accumulate nonearning assets. Taking the business sector as a whole, the merger and acquisition mania added massively to overall indebtedness, while adding absolutely nothing to the aggregate capital stock. In essence, it was buying existing firms at ridiculous prices.

On top of these two financial follies, the corporations applied a third one undermining their balance sheets: In order to boost profits per share, they drastically curtailed their equity base.

It is generally accepted that resulting weak balance sheets have become another obstacle to higher corporate capital investment, and that it therefore urgently needs their rebuilding. Assessing such efforts, we focus on changes in three items: debts, business saving (undistributed profits) and net corporate equity issue.

Slashing their net investment, corporations have drastically slowed the growth of their net indebtedness. But this does not improve balance sheets. That requires the rebuilding of the equity base. For that, however, there are only two main ways available: higher corporate saving through retained profits and equity issuance.

During the recovery from the 1991 recession, for example, business savings or undistributed profits shot up from $10.3 billion to $119.6 billion in 1997, even though corporations sharply raised their dividends.

This time, the situation is dramatically different. As corporations are raising their dividends in the face of a profit carnage, their internal savings have collapsed into negative territory. In the second quarter of 2003, they were $102.8 billion in the red.

As an alternative, the equity base could, of course, be rebuilt by issuing shares. But net equity issues remain slightly negative. Putting it plainly and bluntly: Corporate balance sheets are not being rebuilt; they are being further decapitalized.

LOOKING FOR "TRACTION"?

From our prior analysis of investment conditions and profit prospects, we have drawn the conclusion that there is no chance for the investment recovery that a self-sustaining economic recovery requires. The countervailing, structural forces are too strong and, what is worse, they are not improving. But if investment spending fails to join consumer spending to the upside, the latter is sure to join the former to the downside.

There are many strange things happening in the U.S. economy. Most strange and also most ominous is meanwhile the atrocious discrepancy between absolutely uncontrolled money and credit creation and its minimal effects on the real economy. In the second quarter of 2003, total financial and nonfinancial credit growth of $.3.4 trillion compared with $420 billion nominal GDP growth, both at annual rates.

In step with it, the money supply has been skyrocketing. American economists tend to focus primarily on the money supply, the general conclusion being that its rapid growth means soaring liquidity in the whole economy. Considering at the same time the rock-bottom short-term interest rates, it is for them a foregone conclusion that the spending of this money can only be a question of time. All it needs for that is confidence.

Obviously, it needs some clarifications about the process of money and credit creation. The first thing to realize is that all money creation implicitly derives from credit and debt creation. It is essentially all borrowed liquidity. That is the first important point to see.

Looking for traction leads to two decisive questions: first, who are the borrowers; and second, for what purpose do they spend the borrowed money? In past times, new borrowing was mainly for business investment and residential building. In essence, it was borrowing that boosted GDP and incomes. That is still true in many countries. But in the United States and a few other countries, these two kinds of borrowing have been increasingly overtaken by borrowing and lending for consumption and financial speculation since the 1980s.

While capital investment has inherent limits that also set limits to the borrowing for this purpose, borrowing and lending for consumption and speculation can be stretched to extraordinary extremes through asset bubbles. Trying to sustain the growth in consumer spending, the Greenspan Fed has become a serial bubble blower.

In the first place, it is our principal view that borrowed liquidity, as against earned liquidity, cannot be considered as genuine liquidity. In any case, it is a very precarious kind of liquidity, crucially depending on the stability of the borrowers and their asset values.

Pondering the poor traction of the current runaway money and credit creation, the first thing to see is the monstrous trade deficit, implying an equal outflow of money, partly borrowed, partly earned. In order to offset a corresponding contractive effect on the economy, it needs offsetting domestic credit creation. Essentially, all this credit creation financing the important surplus adds nothing to U.S. GDP.

But there is a second, even more important, reason for the gross failure of the runaway money and credit expansion to create a self-sustaining economic recovery with rising employment and underlying wage and salary income. It has to do with the borrowers and the particular use they make of the borrowed money.

TWO DIFFERENT CIRCUITS

The answer lies in the fact that, on closer look, every economy has in reality two different circulations of money and credit. Economist John Keynes distinguished between industrial and financial circulation. Other economists distinguished between income and capital circulation. The quantity of money in the industrial or income circulation buys goods and services, and in doing so, it creates incomes. The quantity of money in the financial or capital circulation tends to raise the prices of existing assets. But these transactions involve no income effects.

In past times, it was a distinction of little importance. The bulk of the borrowing that took place was for investment spending. Implicitly, this kind of borrowing and spending created employment and incomes with

the famous multiplier effects. The same is true for consumer borrowing and spending. But depending on the kind of consumer spending, there are little further effects. To the extent that the consumer buys foreign goods, this has no domestic income effect at all.

The outstanding feature of the economic development in the United States during recent years has been the impetuous expansion of financial activity, most of it sheer financial speculation, involving heavy credit creation. Manifestly, this requires vastly more credit than the simultaneous economic activity. The particular point to see is that all this credit creation for purely financial purposes is happening entirely outside the national product, involving no income creation.

What matters for an economic recovery is not an increasing overall supply of money, but the increases in liquidity that take place in two sectors: businesses and consumers implicitly showing in their balance sheets. These two are the sectors that alone create GDP and incomes with their spending on goods and services.

Having looked earlier at business balance sheets, we noted that corporations, paying higher dividends increasingly with borrowed money, are definitely losing liquidity. The consumer, too, has shrinking income growth. That is, first of all, negative for liquidity.

But he enjoyed considerable wealth gains through the sharp rises in house prices, against which he increased his indebtedness since end-2001 by $1,231 billion. Borrowing considerably in excess of his current spending on goods and services, he used the surplus to buy real estate, stock shares and to build up liquid assets.

Consequently, he has increased his liquidity. But this has its precarious counterpart in the wealth effects of rising market values of houses and stocks. For us the end of their rise and the associated spending is only a question of a few months.

Viewing the vast flows of money and credit pouring into the U.S. economy, we are tempted to say: Liquidity is everywhere, except in the coffers of consumers and businesses. But they alone are the ones who have to fuel the economic recovery.

Earlier we analyzed the macroeconomic conditions on which such a recovery depends. Our verdict was that they are too bad for a sustained healthy recovery. Taking a closer look at balance sheets, we conclude that financial conditions are no better. In short, the emperor has no clothes.

DOLLAR DOLDRUMS

Fears of sustained downward pressure on the dollar swept through the financial markets around the world in response to the public statement by the G7 central bankers, assembled for the annual meeting of the International Monetary Fund in Dubai, to endorse *"more flexibility in exchange rates... to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."*

It strikes us as very odd in the first place that there is only talk of necessary adjustments in the financial system. That is precisely the key fallacy in the general thinking about the enormous trade imbalances. At their root are imbalances in the real economies. All the surplus countries have high savings and investment ratios, generating more supply than domestic demand; America is a low-savings and investment economy where an extremely powerful credit machine is permanently creating domestic demand vastly in excess of current production.

Strictly speaking, there are two different causes behind the explosion of the trade balances in the past few years: first, chronically higher demand growth in the United States than in the Asian and European surplus countries; and second, heavy structural imbalances and distortions in the generation of savings, investments and consumer demand. Around the world, the propensity to borrow and to lend is far below that in the United States and, for example, also in the United Kingdom.

In actual fact, this extraordinary burst into unprecedented global imbalance started off in 1997, and it had its obvious, primary causes in America. Growth of nonfederal credit soared from $584.7 billion in 1996 to

$1,094.5 billion in 1998; personal saving plunged from 7.1% of disposable income in 1993 to 2.3% in 2001; and the trade deficit exploded from $117 billion in 1996 to most recently about $550 billion.

As a matter of fact, during the past 12 months foreign central banks have increased their pile of U.S. bonds in the Federal Reserve by another $152 billion, now rapidly approaching a trillion. The chief buyers, as is well known, are just two central banks: Japan's and China's. These record-high purchases by central banks reflect, of course, the fact that private capital inflows have dramatically subsided. This says something about the dollar's strength.

Is it a good or a bad idea that central banks stop to support the dollar? We would say it is inevitable over time, and as a rule, the earlier done, the better. But considering the monstrous size of the U.S. trade deficit, it is very late to do this. The safest thing to forecast is the dollar's fall. But keeping the huge mass of foreign capital in America and attracting even new capital inflows is definitely a Herculean task.

This raises the question, will a lower dollar do the job of unwinding the U.S. trade deficit? Our answer is a resounding no. Our main contention is that the huge trade deficit has more deeper-seated causes than just the overvalued dollar.

Its fundamental cause is that Americans are consuming far more than they earn and produce. More precisely, it has three interrelated causes: overconsumption, undersaving and underinvestment. To have external adjustment, it needs internal adjustment. There is no intention to do the latter.

CONCLUSIONS:

Measured by the hard economic data of employment, income growth, production and new orders, the U.S. economy is at best stagnating, if not weakening. Its apparent acceleration has its main causes in sharply higher government spending and the big deflator for business investment in computers.

We wonder when this fact will sink into general realization around the world. It will shatter all recovery hopes and pull the rug out from under the dollar and global stock markets. Consider also that virtually no ammunition is left both for fiscal and monetary policy.

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